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Abstract (Document Summary)

This also is the scenario that some investors believe could be unfolding in the lucrative market for initial public stock offerings. An academic study in November found an unusual uniformity of fees charged for moderate-size IPO stock deals at 7%. Investors quickly sued. And now the same team that pursued the [Nasdaq](#) case at the Justice Department is asking questions about possible collusion on IPO fees.

But that is essentially where the similarity ends, at this point. There are many differences between Nasdaq and the IPO market, which could make the IPO probe more difficult for both regulators and plaintiff lawyers to pursue successfully.

"What settled the [Nasdaq](#) case at that \$1 billion-plus level was not simply the study, important though that was," said John Coffee, who specializes in securities law at Columbia University's law school and served as an expert witness in the [Nasdaq](#) settlement. "It was the telephone tapings which showed [Nasdaq](#) dealer after dealer threatening reprisals to other dealers who narrowed the quote inside of the normal 1/4-point spread."

Full Text (1386 words)*Copyright Dow Jones & Company Inc May 4, 1999*

NEW YORK -- For some Wall Street executives, the sequence of events is chillingly familiar.

An academic study spotlights marketprice anomalies. The study sparks investor litigation. A government

investigation begins looking for evidence of collusion.

That is what happened in the mid-1990s in the Nasdaq Stock Market, where a few dozen dealers, accused of keeping trading "spreads" between bid and asked prices artificially wide, eventually settled for a total of more than \$1 billion.

This also is the scenario that some investors believe could be unfolding in the lucrative market for initial public stock offerings. An academic study in November found an unusual uniformity of fees charged for moderate-size IPO stock deals at 7%. Investors quickly sued. And now the same team that pursued the Nasdaq case at the Justice Department is asking questions about possible collusion on IPO fees.

But that is essentially where the similarity ends, at this point. There are many differences between Nasdaq and the IPO market, which could make the IPO probe more difficult for both regulators and plaintiff lawyers to pursue successfully.

The biggest one is that the Nasdaq dealers moved quickly to settle after they were forced to produce tapes of their traders threatening, cajoling and bullying other traders to adjust their bids to keep spreads wide at customers' expense.

"What settled the Nasdaq case at that \$1 billion-plus level was not simply the study, important though that was," said John Coffee, who specializes in securities law at Columbia University's law school and served as an expert witness in the Nasdaq settlement. "It was the telephone tapings which showed Nasdaq dealer after dealer threatening reprisals to other dealers who narrowed the quote inside of the normal 1/4-point spread."

Will similar evidence come to light of such conduct by Wall Street's elite investment bankers? Edward Fleischman, a former commissioner of the Securities and Exchange Commission now with Linklaters & Paines, doubts it.

"Maybe it's because the trading community is rougher and the investment-banking community is more kid-gloved," he said, "but I would be extraordinarily surprised if there's anything like that kind of smoking gun in this one."

The trading-desk tapes were made routinely to settle disputes; comparable tapes of investment bankers' colloquies aren't known to exist.

Not every IPO has a 7% fee, of course. Corporate issuers launching large IPOs often have the leverage to negotiate smaller IPO rates. And there are other industries with seemingly "standard" rates: Real-estate brokers, for instance, often receive 6% sales commissions. But real-estate commissions at all levels routinely are discounted.

Nevertheless, building a case of IPO collusion wouldn't necessarily require videotaped handshakes in a smoke-filled room. As the civil lawsuit filed last November by the firm of Kirby McInerney & Squire LLP put it, investment bankers could discipline firms that chose to compete on price by keeping them out of membership in so-called syndicates of firms that join to underwrite most deals.

Without offering any evidence that such a scenario had occurred, the complaint said: "For a given IPO, the non-lead underwriters may threaten to exclude from syndicate membership in future IPO offerings a lead manager that proposes to charge a fee lower than the standard 7%."

Columbia's Mr. Coffee says that kind of threat can help point to improper conduct in civil antitrust cases. "You don't have to have two people in a motel room saying 7% {if} you can show behavior that strongly supports the existence of some kind of implicit agreement."

One person close to the Justice Department probe said the department is sifting for evidence of active collusion on price by underwriters, or, in the absence of direct collusion, any evidence of retaliation against companies that have gone outside the implicit pricing zone. The same person also said the inquiry parallels the Nasdaq probe, with much the same set of pricing issues and allegations.

It's a complicated issue and a difficult allegation to prove, this person said. Is there an agreement, or simply a case of price leadership? He added that the probe is only at a preliminary stage, and that the investigation is likely to

take a long time. Still, issuance of civil subpoenas to major Wall Street securities firms seeking information about their IPO fees means the department is taking the allegations seriously.

What's more, the IPO-pricing probe also differs from both the Nasdaq case and another high-profile antitrust case against Microsoft Corp. in lacking, so far, a clearly defined business group with grievances against the subject of the probe.

At Nasdaq, rival dealers tried to make money by making bids inside the quarterpoint spread; some helped gather evidence of improper conduct by other traders. And the Microsoft case, also brought by the Justice Department, has featured testimony from smaller rival software companies claiming to have been injured by Microsoft's market dominance.

The study behind the IPO case, by Hsuan-Chi Chen and Jay R. Ritter of the University of Florida, offers a variety of more benign explanations in addition to "the possibility of implicit or explicit collusion" for the high frequency of 7% spreads for deals between \$20 million and \$80 million.

Other factors could be more important to companies selling their stock in an IPO, the study notes. These include the quality of the securities firms' research on their industry, the underwriters' prestige and track record, the price level the IPO may fetch at the offering, and where the stock will trade once trading begins.

For many companies that sell stock in IPOs, investment bankers note, the magnitude of a difference between a fee of 7% or 5% pales when compared with the range of possible offering prices, as well as how much the stock rises immediately after the offering price is set. Most IPOs historically have been priced so they can increase by about 15%, more or less, on the first day of trading.

Nor would most companies have an incentive to complain. The fortunes of public companies hinge on their stock price, which is heavily dependent on Wall Street research. And if they have any notion of selling more stock after the IPO, as most do, they wouldn't necessarily be inclined to come forward.

Mr. Ritter said in an interview Sunday that he had talked to a litigation consultant in Silicon Valley before releasing his study. The consultant, he said, asserted that companies that had sold stock in IPOs were unanimously not interested in pursuing such a complaint.

Garrett Rasmussen, a specialist in antitrust law at Patton Boggs LLP in Washington, notes another potential obstacle to finding improper collusive activity. "There are so many lawyers involved in the IPO process, it's so lawyer-intensive, I suspect you're never even going to find conversations about rates."

Several Wall Street lawyers recalled that 50 years ago, the government ignominiously lost an epic antitrust case against 17 securities firms led by Morgan Stanley & Co.. The U.S. had charged that the firms were colluding to monopolize the underwriting business via an elaborate hierarchy that precluded poaching each other's clients, said Samuel L. Hayes, a finance professor at the Harvard Business School.

After that setback, Mr. Hayes recalled, the underwriting system remained largely intact for many years -- until some "nontraditional" firms outside the system, such as Merrill Lynch and Salomon Brothers, forced their way in "by having distribution power that could not be denied."

John R. Wilke in Washinton contributed to this article

[Table]

Is It Sometimes 'Collusion Street'?

Recent accusations of collusion in the securities industry:

MARKET (YEAR): Nasdaq dealers (1994)

INVESTIGATION: Nasdaq Stock Market's biggest market-making firms

accused of price-fixing, first spotted by two professors in 1994.

STATUS: Justice Department settled with firms in 1996; investors who had sued the firms settled in 1997 for a total of more than \$1 billion.

MARKET (YEAR): Bonds (1999)

INVESTIGATION: Investors and regulators say securities firms control bond pricing information.

STATUS: Bill recently passed committee of the House mandating SEC to create systems to distribute corporate bond pricing information.

MARKET (YEAR): Options (1999)

INVESTIGATION: Justice Department investigates whether options exchanges restrain competition.

STATUS: Pending.

MARKET (YEAR): IPO Underwriting (1999)

INVESTIGATION: The Justice Department is looking for evidence of price-fixing of IPO fees.

STATUS: Preliminary-inquiry stage after academic study showed 90% of IPOs between \$20 million and \$80 million carry 7% fee.

Credit: Staff Reporter of The Wall Street Journal

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